Central bankers commit to rate hikes amid growing signs of recession

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Major central bankers attending the European Central Bank's (ECB) annual meeting on monetary policy in Sintra, Portugal this week, have made it clear interest rate hikes will continue, even if this means pushing the economy into a recession.

There were varying degrees of public commitment to a hard monetary policy, reflecting different national conditions and the problems they present, but the direction was the same.

US Federal Reserve chairman Jerome Powell said he was more concerned about the need to stamp out high inflation than the risk an increase in interest rates could spark a recession.

"Is there a risk we go too far? Certainly there's a risk," he said. "The bigger mistake to make… would be to fail to restore price stability."

But as Powell and other central bankers have acknowledged, raising interest rates will do nothing to bring down inflation which has been engendered by the supply of trillions of dollars to financial markets over the past decade and a half, the refusal of capitalist governments to take action to eliminate COVID-19 and the effects of the US-led NATO war against Russia.

Central bankers and other representatives of the capitalist state and finance capital always seek to present their policies as being based on sound economic knowledge and that they act in the interests of the mass of the population.

But there was an exposure of this fiction when Powell was pressed on whether central banks now had a better grasp of inflation dynamics. "We now understand better how little we understand about inflation," he responded.

But one thing that is well understood, based on the interests of capital they serve, is that rate rises are necessary to try to crush the growing movement of the working class to lift wages in the face of the highest inflation in 40 years.

"There's a clock running here," Powell said. "The risk is that because of the multiplicity of shocks, you start to transition into a higher-inflation regime. Our job is literally to prevent that from happening, and we will prevent that from happening."

The process was "highly likely to involve some pain." He did not spell it out but what it means is a major contraction in the economy which drives up unemployment to end what Powell has characterised as a "very tight" labour market. Recently, former treasury secretary Lawrence Summers indicated that 10 percent unemployment rate for a year would be needed.

As Powell was delivering his remarks on Wednesday, there were further indications that a significant slowdown in the US economy has already begun.

The Commerce Department increased its estimate for the contraction in economic output in the first quarter from 1.5 percent to 1.6 percent. The main cause for the revision was the estimate that consumer spending over the three months was weaker than previously thought, coming in at annual an increase of only 1.8 percent compared to the previous estimate of 3.1 percent.

The first quarter contraction was initially dismissed as something of a statistical aberration, but it is now being regarded as the start of a trend as growth estimates for the June quarter are revised down. IHS Markit analysts expect second quarter growth to be only at an annualized rate of 0.1 percent compared to their previous forecast of 1 percent, with the estimate of the Atlanta Federal Reserve at 0.3 percent.

ECB president Christine Lagarde was somewhat more circumspect on rate rises but left no doubt about the direction of policy. She said there was a need to move gradually if there was uncertainty about the outlook "with the option to act decisively on any deterioration in medium-term inflation, especially if there are signs of de-anchoring of inflation expectations."

The term "de-anchoring" means a situation where workers in Europe, facing inflation already at more than 8 percent and expected to go higher, demand significant wage increases.

Lagarde also pointed to the worsening economic conditions in Europe. Private consumption was still 2 percent below pre-pandemic levels, investment remained "subdued," while inflation pressures were "intensifying and spreading through the domestic economy."

Households were seeing their real incomes squeezed, real wages had fallen for two consecutive quarters, businesses were delaying investment decisions, sales growth "now appears to be decelerating" and "business expectations have reached their lowest level since October 2020."

In her remarks, Lagarde pointed to the reasons for her more guarded response on the need for rate hikes. She noted that the euro area has a "unique institutional set-up, built around 19 not yet fully integrated financial markets and 19 national fiscal policies, with limited coordination."

In other words, the euro zone is bedevilled by one of the central contradictions of the capitalist system identified by Marxist political economy, which is the continental and global character of production, within the divided, capitalist nation-state system.

Lagarde said the structure of the euro zone—in which a single currency is needed under conditions where economic and financial activity is continental in scope but nation-states with their own policies remain—presented the risk of ECB policy being "unevenly transmitted across the union."

This refers to a situation of so-called "fragmentation" in which, under conditions where the ECB raises rates and tightens its monetary policy, interest rates on the bonds of the more indebted countries, such as Italy and Spain, rise more rapidly than those of the stronger economies, principally Germany.

Fragmentation came close to leading to the collapse of the euro in the face of the European banking crisis of 2012, which was only prevented by then ECB president Mario Draghi's commitment to do "whatever it takes" to maintain the single currency.

In an effort to prevent the re-emergence of this crisis the ECB convened an emergency meeting last month, immediately after the Fed's decision to lift rates by 0.75 percentage points, with more to come.

The meeting decided to set up a new mechanism to prevent what Lagarde has described as "unwarranted fragmentation." No details were provided, and a report is being prepared for the ECB's governing council, possibly to be presented at its meeting later this month. According to one estimate, had the ECB not called the emergency meeting the interest rate on Italian bonds could have risen rapidly.

But the adoption of a new mechanism will not be plain sailing because of the national divisions within the euro zone.

The warnings by Lagarde of bond market fragmentation and a new mechanism came under attack from Germany's finance minister Christian Lindner at a closed-door meeting on June 16. According to a report in the *Financial Times* he told Lagarde that "talking about fragmentation in the bloc's financial markets could damage confidence."

Speaking publicly before the meeting he said the euro area was "stable and robust" and while the interest rate spreads on the bonds of member states were widening, their current levels indicated "no need for any concern." He was backed by Dutch finance minister Sigrid Kaag, who said it was important to "project confidence and calm" and not to "express ourselves prematurely."

Lagarde reportedly told the meeting the ECB had to address "fragmentation risk," that it was a "serious threat," and "doubting our commitment would be a serious mistake."

She has repeated these positions, telling members of the European Parliament the ECB was determined to nip fragmentation in the bud.

There are two conclusions to be drawn from the ECB gathering. The first is that central bankers are determined to press ahead with interest rates to deepen the global offensive against the working class, regarding this as essential to the profit system over which they preside.

But secondly, and even more significantly, this offensive is not being undertaken from a position of strength. It is being launched amid a deepening economic crisis for which they have no solution; all the mechanisms employed in the past break down under conditions of a rising movement of the working class.